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National Venture Capital Association

April1, 2005

Delivered by facsimile and electronic mail

Gary M. Jackson
Assistant Administrator For Size Standards
Office of Size Standards
Small Business Administration
409 Third Street, SW
Washington, DC 20416

Re: **Proposed Rulemaking Affecting SBIR Eligibility**
RIN #: **3245-ZA02**

Dear Mr. Jackson:

The National Venture Capital Association (NVCA) is a trade association that has represented the U.S. venture capital industry since 1973. It is a 460-member organization, which consists of venture capital firms that manage pools of risk equity capital designated for investment in high growth companies-- driving U.S. innovation and providing the engine for new job formation. Essential to innovation and job creation is access to funds targeted for new research. Venture capital funded companies attract top quality scientists who desire to pursue innovative research and development in smaller companies with greater opportunities. For this reason, many of these companies seek to be, or are, recipients of Small Business Innovation Research (SBIR) awards and venture capital financing. We appreciate the opportunity to comment to the Small Business Administration (SBA) in response to its Advance Notice of Proposed Rulemaking (ANPRM)[1] seeking comment on the participation of businesses in the SBIR program that are majority-owned by one or more venture capital companies (VCC).

Defining a VCC as a VCOC.

In the ANPRM, the SBA seeks comment as to whether it should propose to exclude VCCs from affiliation or to provide some other type of exemption for VCC investments. The SBA has already included a number of exclusions to affiliation regarding grants under the Small Business Investment Act (SBIA). In these provisions, VCC has the same definition of a venture capital operating company (VCOC), as defined in U.S. Department of Labor regulations.[2]

Generally, in order to qualify as a VCOC, an entity must have at least 50% of its assets invested in an operating company in which it has management rights that the fund actually exercises at least once per year. Management rights are contractual rights by which the VCOC can have a vote at a policy level on certain well defined corporate decisions of the company as

[1] 69 Fed. Reg. 70197 (December 3, 2004), as amended by 70 Fed. Reg. 2976 (January 19, 2005).
[2] 29 CFR 2510.3-101(d)

part of protecting its investment in a high risk entity. These are not rights to participate in day-to-day management but rather are typically decisions regarding the aggregate amount of debt a company can incur or the sale of the operating company or its assets. These rights are no different than the type of rights that a large individual investor in a privately held company would seek and expect to get to safeguard their investment.

We use the term "VCC" throughout this letter assuming the same definition of "VCC" that the SBA has, namely, as defined in the U.S. Department of Labor regulations as a VCOC.

SBIR History.

The SBIR program was created by the Small Business Innovation Development Act of 1982 (SBIDA). The purposes of SBIDA, as defined by the statute, are to stimulate technological innovation, to use small business to meet Federal research and development needs, to foster and encourage participation by minority and disadvantaged persons in technological innovation, and to increase private sector commercialization of innovations derived from Federally funded research and development. SBIDA implements Congressional policy to give assistance to small-business concerns to enable them to undertake research in order to maintain and strengthen the competitive free enterprise system and the United States economy. To promote this policy, Congress recognized that funds provided under the SBIR program would encourage private investment and "facilitate the ability of participating firms to attract venture capital."[3]

The Small Business Reauthorization Act of 2000 reauthorized the SBIR program until September 30, 2008. The purposes of this reauthorization were, among others, to expand and improve the SBIR program, stimulate technological innovation, use small businesses to meet Federal research and development needs, and strengthen the technological competitiveness of small businesses in the United States. In order to accomplish these purposes, however, substantial investment of capital outside of what the Federal government is able to provide is and will continue to be needed. The venture capital industry has been a major player in fulfilling this additional need since the program's inception 25 years ago. However, the current interpretation of the regulations prevents small business concerns with SBIR funding from raising the capital necessary to pursue their discoveries.

Prior to December 3, 2004, to be eligible for an SBIR award, at least 51% of the ownership interests in the business concern seeking SBIR funding must be owned and controlled by one or more individuals who are citizens of the United States, or permanent resident aliens in the United States[4]. Furthermore, an SBIR awardee, together with its affiliates, could not have more than 500 employees (the "500 Employee Rule").[5]

The definition of an "individual" was interpreted in January 10, 2001, when an Administrative Law Judge (ALJ) ruled on the size appeal of CBR Laboratories, Inc., an SBIR award applicant.[6] In the decision, the ALJ ruled that a firm that is otherwise eligible for an SBIR

[3] S. Rep. No. 97-194, 97th Cong., 1st Sess. 1981, reprinted in 1982 U.S.C.A.A.N. 512.
[4] 13 CFR § 121.702
[5] Id.
[6] *Size Appeal of CBR Laboratories, Inc.*, SBA No. SIZ-2000-10-16-32 (2001).

award is disqualified because it is wholly owned by another entity. At issue in that decision was whether or not the SBIR requirement that an applicant be majority owned and controlled by U.S. individuals should be interpreted to mean only natural persons, thereby excluding entities such as corporations. This was the first time this issue had been presented for review, and despite the lack of statutory or historical Congressional support, the ALJ ruled that "individual" should indeed mean "natural persons." In fact, the ALJ specifically discounted other statutory uses of the word, "individual" where it was defined to include entities, but while simultaneously acknowledging that the legislative history of the SBIR program discusses only generally the need to reverse the decline in American technological innovation and competitiveness and that Congressional reports do not discuss individual ownership of SBIR awardees as opposed to entity ownership.

Since CBR Laboratories, the SBA has solicited numerous comments on its size requirements for applicants. On December 3, 2004 (effective January 3, 2005), the SBA issued a final rule, stepping away from its "wholly owned by individuals" stance which came into play in CBR Laboratories, but still requiring that an SBIR award recipient must be a for-profit business concern that is at least 51% owned and controlled by one or more individuals who are U.S. citizens, or 51% owned and controlled by another for-profit business concern that is at least 51% owned and controlled by one or more individuals who are U.S. citizens (the 51% Rule).[7] Applicants who meet the ownership criteria in the 51% Rule, however, are still subject to SBIR size standards, most significantly, limiting the number of employees of the applicant and its affiliates to 500 employees.

It is important to recognize that since the program's inception until 2003, when the CBR Laboratories decision was interpreted against Congnetix, Inc., venture-backed companies regularly and fully participated in the SBIR program without incident or exploitation. This long-standing relationship positively reinforced the intent of Congress and helped to ensure the program's commercialization success.

The SBA is now seeking comment as to whether VCCs should be excluded from this definition of affiliate when determining small business eligibility for the SBIR program.

While we applaud the SBA's recognition in the 51% Rule that a business concern can be technically both majority-owned by VCCs and still eligible to receive an SBIR award, it does not fully accomplish the goals of SBIDA, since as stated herein, the majority of limited partners in a VCC are not individuals. We believe that a pragmatic framework for the current regulations that reasonably allows VCC-financed small businesses to receive SBIR grants is still several steps away. **We believe that the SBA should (1) provide an exclusion from affiliation with VCCs in determining small business eligibility with respect to the 500 Employee Rule and (2) further extend an exception to the 51% Rule to include VCCs in the definition of "individuals."**

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[7] 69 Fed. Reg. 71080.

Venture Capital has been a critical factor to the growth of technology in the US.

In order to commercialize any new technology, including new technologies subject to SBIR grants, a company must obtain capital at levels that will ensure the success of the company's efforts. The venture capital industry has been critical to the success of many of these companies by providing the funds necessary for the development and commercialization of new technologies in the United States.[8] Employment in venture capital backed companies jumped 6.5 percent between 2002 and 2003; more than triple that of the non-venture backed company employment rate of negative 2.3 percent growth.[9] The combination of the SBIR program fueling small business research coupled with venture capital dollars funding development and commercialization has created unprecedented innovation and job creation from small businesses in the United States since the program's beginning 25 years ago.

VCCs are investment vehicles that are funded themselves by investments from indepen9dent investors. By aggregating a broad range of investors[10] into limited partnership funds that can invest in these new technologies, VCCs provide an efficient and cost effective method whereby companies can obtain the funds needed to drive the commercialization. Once funded, venture capital backed companies attract top scientists to conduct research and development at the company, with the aim of commercializing that research and getting successful products to market.

SBIR is vital to technology development in US venture funded small businesses.

Because a venture capital fund is an investment fund, however, its focus is on generating a return for its investors, similar to the goals of an individual investor. For this reason, the independent management of a venture capital backed company focuses on commercializing technology once it is off the bench top—not on early stage research. Usually venture-backed companies will need to raise funds in more than one round of financing before it can achieve profitability. This series of financings can equate to several million dollars to get a single product to market. Without focusing on a commercialization strategy as opposed to broad research objectives, venture backed companies could not attract investors to provide necessary capital because the time and expenses associated with such a strategy would be beyond the resources a venture investment could provide.

SBIR funding is vital to the success of both venture-backed companies and companies seeking venture funding. SBIR funds are used by companies to fund the next generation research that may not otherwise be funded in the companies' budget. It is the scientists at the venture-funded company, not the Board of Directors nor its investors, who determine these new

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[8] In 2003, venture funds provided over $18 billion in funding to seed, early, expansion and later stage companies. See the Year Book, at 11. By comparison, companies funded through corporate investments were far less at approximately $1.1 billion.

[9] Global Insight Venture Impact 2004

[10] In 2003, capital commitments in venture capital funds came from private and public pension investments (43%), financial and insurance sources (25%), individuals and families (10%), endowments and foundations (21%) and corporations (non-employee benefit) (2%). It is of note that private and public pensions and individuals and families constitute 53% of the capital committed to venture funds.

areas of exploration and apply for SBIR funds. Without SBIR funds, the scientists at venture funded companies may not have the funds for the next innovation. The reason for this is simple.

In 2003, the average investment in the 254 biotech companies funded was $13.3 million.[11] But these funds are not necessarily sufficient to meet the company's growth needs before it can be profitable. For example, with the average cost of bringing a new drug to market being $800 million[12], biotechnology companies usually cannot divert precious funds to untested projects - projects which may hold the next ground breaking discovery. It is important to remember that venture capitalists invest other people's money. Before investing in a start-up company, a venture capitalist must be assured that there is a very good chance that company could become successful in a set period of time. If good technology is short of that funding threshold, additional support is necessary before that technology can be commercialized. Otherwise that product will languish on the shelf of the small business. Since most venture capital backed companies employ top scientists to conduct ground breaking research, it is critical to the United States economy that venture investment and SBIR grant awards not be mutually exclusive but work in a symbiotic fashion to promote the goals of SBIDA. But there are still significant impediments to attaining these goals and the current interpretation of fifty-one percent ownership and control for purposes of qualifying as a small business for SBIR grant award threatens to undermine the long-term success of America's most innovative small businesses.

While the recent amendment to the 51% Rule now allows an SBIR award recipient to be owned by a VCC, as long as the VCC is itself owned and controlled by U.S. individuals, this does not cover the vast majority of the VCCs to which small technology companies receive investment. Investments by venture capital are commonly high risk, early stage investments. Due to the risk associated with those investments, it is common for a significant percentage of a small business's equity to be owned by one or more VCCs or syndicates. VCCs, themselves, are commonly structured as limited partnerships or limited liability companies and the investors in VCCs are generally comprised of private and public pension funds, financial and insurance investors, endowments and foundations, and to a smaller extent individuals and families. It is the ownership of the VCC partnership that continues to prevent most venture-backed companies cease to be eligible for SBIR funding, even under the new 51% Rule.

VCC "Individual" Ownership Exclusion.

We believe that the SBIR eligibility requirements should not differentiate between natural persons and other legally recognized entities with respect to VCCs. There is no statutory or legislative support, including the SBA's own legislative history, for the regulations which limit eligible awardees under the 51% Rule to those owned by "individuals". Congressional intent in passing SBIDA was to increase the amount of Federal research and development support for highly innovative small businesses, bolstering the competitive position of the United States. Therefore, the current interpretation of the 51% Rule and its result is inconsistent with SBIDA.

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[11] PricewaterhouseCoopers/Thompson Venture Economics/National Venture Capital Association Money Tree Survey (NVCA Yearbook 2004)
[12] Journal of Health Economics, vol 22, p 151

Instead, the effect of the 51% Rule will be to continue to prevent many small businesses that have received venture financing from receiving SBIR financing, and vice versa, thereby undermining competitiveness and job creation produced by an active high-tech start-up community. Technology-based emerging companies need to seek venture capital or other forms of capital to support the significant costs of research, development and commercialization of new technologies. This is particularly true in the capital-intensive biotechnology and medical device industries.

VCCs primarily seek to invest in small start-up companies for the possibility of financial returns and further innovation. While VCCs, as investors, typically have Board participation (usually two or three seats of a five to seven member Board), as stated before, VCCs do not exert day-to-day control of a company. Some of these reasons are practical. The portfolio managers at venture funds manage a number of portfolio company investments at once. Their time is divided between all investments of the venture fund and it would be impossible to have a significant level of participation in management. Second, the VCC's relationship with a portfolio company is that of investor, and not a partner. At no time can one argue that the operations and profits of the VCC are blurred with those of the applicant company. Unlike corporations, VCCs are usually limited life entities that make their return on investment only when the portfolio company is sold or makes a public offering of its securities.

Venture capital investment is not corporate investment. In fact, corporate (non-pension fund) investment in VCCs in 2003 amounted to less than 2% on all investments in VCCs. Furthermore, venture funded companies are often financed by a group of unaffiliated VCCs, known as a syndicate, which in most cases no single VCC owns a majority of the company, but that together can equal more than 51%. Typically, a venture-backed company will seek financing from on average three to five venture capital funds, and will raise money in a number of financing rounds. Not all of the venture investors will provide the same level of funding and only some of the participating funds may have representation on the board of directors.

Unlike a corporate investor, each type of venture fund has its own investment objectives, unique investment goals, and different investors along with different management. VCCs are commonly structured as limited partnerships or limited liability companies, and investments are commonly (although not exclusively) high risk, early stage investments. The VCC manages pools of capital from a variety of sources while making investments in small companies. Private and public pension funds provide forty-three percent of this investment capital. The remaining capital commitments in VCCs are constituted from financial and insurance investments (25%), endowments and foundations (21%), individuals and families (10%), and corporations (2%). VCCs compete aggressively for the best investments not only as to the size of the investment being made, but as for representation on the board of directors. The investors who do not get the chance to have a board seat may negotiate to have "observer rights" but have no vote on the board and in fact observers can be excluded from board meetings for reasons of confidentiality, among others. Therefore, unlike a corporate investment, there is no single controlling entity or interest other than a desire to see it succeed and gain a return on investment. For this reason, the inclusion of VCCs as individuals is reasonable and furthers the policies of SBIDA.

VCCs should be treated as individuals in determining SBIR eligibility.

We suggest that the SBA propose a rule that the term "individuals" in the current regulations[13] be defined to include both natural persons and VCCs, in addition to other types of entities the SBA may decide should be similarly included, e.g., employee benefit or pension plans, non-profit organizations, etc. By doing so, the SBA will ensure that SBIR granted companies will not only have the resources but the capital to ensure the commercialization of the funded project. Such a modification would permit small businesses which are funded by venture capital funds to be eligible to receive SBIR awards, would help prevent the obstructions to capital formation raised by the 51% Rule, and would help to further the Congressional goals of establishing the SBIR program. Finally such a rule is consistent with the non-corporate investment character of VCCs and their investments.

The remainder of our comments address the issues raised by specific questions posed in the ANPRM of December 3rd, 2003, as to likely impact of the necessary rule change to allow venture-backed companies to again fully participate in the SBIR program:

The merits of SBIR participants would not be affected.

The composition of SBIR participants should not be affected by allowing venture-financed companies to participate in the program. The SBIR program has always awarded companies grants based on the scientific and technical merit and commercial feasibility of ideas that appear to have commercial potential. Even if the SBIR program is re-opened to venture financed companies, this would not change the fact that SBIR award winners are competitively selected using peer review or scientific review criteria. Awards will continue to be granted upon the scientific and technical merit and feasibility of the proposals. Geography has not traditionally played into the consideration for granting SBIR awards, and an expansion to again include venture-financed companies will not have any predictable impact upon the geographical location of award winners or tilt the program in favor or away from lower-risk technologies. Commercial potential has always been and always will be considered in applicants, and allowing venture-financed companies to compete will not alter this and the program's other criteria, but will instead enhance the probability of overall commercial success.

Firms and projects that would benefit.

As previously stated, SBIR awards are granted on the basis of peer review for scientific merit and commercial potential. SBIR grants have always rewarded small businesses with the best technology, including venture-financed awardees. Because the review is based on who has the best technology with the most potential, expanding the program to include venture-financed companies would not have any adverse effect on the ability of small business concerns without access to venture capital to compete for the SBIR awards. Expanding the SBIR program would

[13] 13 CFR 121.702.

improve the quality of the technologies being rewarded by increasing the total field of qualified applicants.

Lower potential for repeat award winners.

The participation of venture-financed companies would not create an environment of multiple repeat award winners. The ultimate goal of the SBIR program is as a stepping-stone to successful commercialization. In order to best commercialize their technology, companies will ultimately need to pursue other sources of capital. Having already received an SBIR grant is beneficial to companies looking for additional capital, as it serves as a validation of the innovation, viability, and commercial potential of that technology.

By re-opening the SBIR program to companies that are venture financed, the SBIR program will attract a broad base of applicants, ensuring that the most innovative technologies with the most scientific merit and commercial feasibility will be allowed to compete for awards in order to make the significant step toward commercialization. By identifying these innovative technologies, the SBIR program will enable the ability of these companies to subsequently obtain private capital. Otherwise, by limiting the program to non-venture financed companies, the pool of applicants will be smaller and many innovative technologies will be overlooked. If fewer companies are eligible to receive grants, a more likely result will be an increase in the number of companies that will be tied to the SBIR program for multiple grant awards.

The goal of the SBIR program should be to help the most technologically innovative companies on their road to commercialization. A way to ensure this likelihood is to open the program to the broadest base of small businesses as possible, and this requires allowing venture financed companies to once again compete.

VCC Affiliation Exclusion.

The 51% Rule does allow VCCs to own 51% or more of applicant companies, *however*, the VCC is still required to be at least 51% owned and controlled by United States individuals. The SBA is currently proposing that if an applicant successfully passes the 51% Rule's individual ownership criteria, its VCC investors would be excluded from the definition of affiliate, meaning the requirement that an applicant and its affiliates have fewer than 500 employees would not apply to the VCC.

The SBA has already included a number of exclusions to affiliation regarding grants under SBIA. Specifically, VCCs are not considered affiliates of an applicant, in addition to certain other entities such as employee benefit or pension plans or non-profit organizations.

The SBA should issue a similar exclusion for companies funded by SBIR grants (which are established under SBIDA rather than SBIA). As mentioned previously, VCCs primarily seek to invest in start-up companies for the possibility of financial returns and further innovation. The CEO and the other employees of the company manage day-to-day oversight of portfolio company business operations. VCCs and their companies do not operate in the same manner as corporation and their subsidiaries. Since this blurring of operations does not exist, it does not make sense to aggregate the employees of the applicant with the employees of its VCC investors, or the employees of a venture firm's limited partners. Applicant companies are investments not subsidiaries.

VCC exclusions from affiliation would, albeit incrementally, increase the amount of competitive small businesses with innovative technologies in order to bolster the intent of Congress in the adoption of the SBIR program.[14] Congress has indicated that providing small firms with seed money would encourage further private investment, facilitating the ability of small businesses to attract venture capital and other financial support.

If just the VCC affiliation exclusion rule is proposed and adopted, SBA eligibility requirements would still distinguish between natural persons and other legally recognized entities (*e.g.*, corporations, limited liability companies and limited partnerships) by suggesting that an "individual" can only be a natural person. **While we appreciate the strides the SBA has taken in order to include more venture financed small business in the pool of SBIR award recipients, we believe that the steps taken so far are insufficient.**

We respectfully request that the SBA should:

1. Provide a proposed exclusion from affiliation with VCCs in determining small business eligibility and furthermore; and more importantly,
2. Extend an exception to the 51% Rule to include VCCs in the definition of "individuals."

Thank you for providing us an opportunity to comment on this matter.

Very truly yours,

President
National Venture Capital Association
1655 Ft. Myer Drive, #850
Arlington, VA 22209
703-524-2549

cc: House Small Business Committee
Senate Committee on Small Business and Entrepreneurship
SBA Office of Advocacy

[14] 15 USC 638.